ACRI

Association of Italian Savings Banks

2001 World Savings Day

Address by the Governor of the Bank of Italy

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1. Financial markets

On several occasions, starting in March 2000, I drew the attention of investors, market participants and intermediaries to the discrepancy in the leading markets between share values on the one hand and profits and expected dividends and the level of long-term interest rates on the other.

Only growth rates for profits and dividends two or three times that expected for GDP would have justified the level of stock market prices, even assuming a lower risk premium than had been observed in the past.

In the months that followed, technology stocks began to fall; in the leading markets the general index declined to a lesser extent; in Italy there was a drop of 14 per cent. Prices began to rise again in the summer, stimulated by abundant liquidity and also in response to the favourable performance of the world economy in the second half of 1999 and the first few months of 2000.

At the end of May, I repeated the warning about the discrepancy between stock market prices and underlying economic conditions.

At the same time it was becoming increasingly evident that the acceleration in economic activity in 1999-2000 had also been linked to the abundance of liquidity.

I warned that, in the absence of structural adjustments in the European economies, the growth in demand would create inflationary pressures and thereby frustrate the expectations of an expansion in economic activity. Subsequent developments confirmed this analysis.

In the first half of 2001 the industrial countries recorded a sharp slowdown in economic activity that began in the United States.

In the spring of this year share prices appeared more reasonable compared with the excesses of the previous year, but still would have been justified only by a rapid economic recovery.

In the summer the economic slowdown led to the downward revision of expectations; share prices continued to decline, especially in late August and early September.

The terrorist attacks accentuated the decline. The deterioration in the economic outlook and the problems of some important sectors triggered a new wave of sales. Prices in some sectors fell below the equilibrium level, estimated on the basis of a prudent assessment of the fundamentals.

In mid-September prices in the leading markets were down on average by one-fifth compared with a month earlier, by 30 per cent compared with the spring, and by 40 per cent compared with the peaks reached in the first few months of 2000. Expansionary fiscal policy in the United States and the prompt easing of monetary conditions were conducive to a recovery in prices.

On the Italian market, the movements of the last forty days have brought prices back to a level that appears not inconsistent with their long-term equilibrium values.

It should be noted that there has been a structural reduction in the risk premium on the leading markets.

In the last three or four years markets appear to have been addicted to past trends and blind to future developments.

The call must be repeated, in the first place to analysts and market participants, to assess individual securities realistically with reference to the outlook for growth and profits in each sector and in the light of the general context defined by interest rates, inflation and economic growth rates.

The reputation of intermediaries and market operators is based on their ability to discern widespread and lasting price movements, both up and down. The recent swings on stock markets can clearly be seen as speculative bubbles in which imprudent market operators have been involved; they have been harmful for investors, the orderly conduct of business on financial markets, the financing of investment, and economies as a whole.

The share price level is compatible with positive expectations for 2002 and beyond. These must be verified in the light of developments in the industrial countries. Policy measures must be directed to ensuring economies, and Italy's in particular, succeed in fulfilling these expectations.

2. Economic developments

The US economic expansion, which had begun to slow down in the middle of 2000, virtually came to a halt in the first half of this year as a consequence of the sharp fall in investment, especially in high-tech goods.

The short-term expectations of manufacturing firms and consumers improved during the summer, suggesting the possibility of a cyclical upturn as early as the last few months of this year, partly in response to the tax cuts approved in May and the fall in interest rates.

In the euro area the GDP growth rate in the first half of 2001 dropped to an annualized 1.8 per cent, almost half the average rate in 2000. Notwithstanding a slight acceleration in household consumption, which was boosted by expansionary fiscal measures in the leading countries, growth in domestic demand slowed down owing to the fall in investment, which was especially pronounced in Germany.

In Italy GDP grew in the first half of 2001 at an annual rate of 2.5 per cent, as against 2 per cent in the second half of 2000; the growth all came in the first quarter, with economic activity stagnating in the second. The growth rate in the first half of the year was slightly above that recorded by the other leading euro-area countries; the result benefited from the tax reliefs introduced at the end of last year and the rise in employment.

Investment fell in the second quarter. In the first half of the year it grew by 1.2 per cent. Even factoring in a recovery in the second half, the increase for the year as a whole will be the smallest since 1994.

From May onwards there was an improvement in firms' expectations regarding orders; in July the indicator published by the Bank of Italy and ISAE improved for the third successive month, suggesting the possibility of an upturn at the beginning of 2002.

In the summer manufacturing activity stopped declining and remained at the level recorded in the spring; after falling in July, the index of industrial production recovered in August and is estimated to have remained unchanged in September. Orders, except for investment goods, continued to decline.

At the beginning of September the International Monetary Fund expected the world economy to grow by 2.6 per cent on average in 2001, more than half a percentage point less than the forecast of just a few months earlier. The Fund expected the US and euro-area economies to grow by 1.3 and 1.8 per cent respectively. For Japan it forecast a fall in output of 0.5 per cent.

The terrorist attacks greatly increased the uncertainty regarding the outlook for the world economy. The central banks of the leading industrial countries responded rapidly with joint action that led to a general and significant easing of monetary conditions.

In the United States the effects of the attacks on economic activity have been considerable. They have mainly been due to the temporary interruption of production in some sectors that were directly affected and the sharp fall in demand for some services perceived by consumers to be especially exposed to risk. In September retail sales contracted by 2.4 per cent; purchases of durable and luxury goods fell. In October there was a further deterioration in the climate of confidence among households. In all likelihood business investment — which had already been contracting in the first part of the year owing, among other things, to the fall in profits — will have begun to be affected by the increase in uncertainty regarding demand.

In Europe the climate of confidence among households has continued to deteriorate after 11 September. In Italy the index fell only a little in September and held steady in October. Evidence of changes in consumer spending decisions has been found for some services and for car purchases.

Both the ISAE and the Bank of Italy business opinion surveys conducted between late September and early October revealed a widespread worsening of firms' expectations regarding orders, especially in the short term. Looking further ahead, firms appeared to be more optimistic, probably because they assumed the crisis would be overcome rapidly.

Banks kept conditions in the market for loans easy in the second half of September and in October. Short-term lending rates have come down; their decline is in line with the pattern observed in the past when official rates were reduced.

3. Structural problems

The nineties were marked by rapid technological progress in all the major industrial countries. Radical innovations in information technology and telecommunications fostered the development of new products and far-reaching changes in the organization of production. After growing more slowly in the two preceding decades, International trade expanded strongly under the impetus of the Uruguay Round agreements. The liberalization of national financial systems, together with the application of the new technologies, led to the creation of a single worldwide market in finance.

From the start of the nineties onwards the US economy achieved a significant increase in the rate of capital formation. Between 1991 and 2000 gross investment in machinery and equipment rose from 6.1 to 11.8 per cent of GDP. During the same period investment in new technologies grew at an average annual rate of 16 per cent; the stock of high-tech capital goods rose from 24 to 34 per cent of the total stock of machinery and equipment.

The expansion of the US economy strengthened in the second half of the decade. The rate of labour productivity growth rose to 2.5 per cent, compared with 1.4 per cent in the years between 1973 and 1995. Employment increased substantially. The positive performance of the economy, together with the structural adjustment measures adopted in 1993, contributed to correcting the imbalance in the public finances.

The emerging economies, especially those able to produce medium and high-tech goods, gained from the expansion of trade. Substantial benefits came from the growth and opening up of national financial markets; large flows of foreign private capital made it possible to ease the constraints imposed on growth by the insufficient supply of domestic savings. In the nineties the economies of the developing countries grew at an average annual rate of 5.4 per cent, compared with 4.2 per cent in the eighties. In Asia faster growth was accompanied by a significant reduction in poverty.

In certain emerging economies the abundant inflow of foreign capital, in a context of inadequate systems of banking and financial supervision, and the less than profitable way in which the funds were sometimes used abetted the persistence of deficits on the current account of the balance of payments. This led to financial crises in

Latin America, Asia and other parts of the world, with serious repercussions on living standards.

Many backward economies in Africa, Latin America and Asia did not benefit from the liberalization process, since they lacked the basic conditions for attracting private capital; their only sources of finance remained the official ones.

In Europe economic growth was sluggish, with activity expanding at a rate more than 1 percentage point below that of the United States: 2.1 against 3.2 per cent. In the euro area the general government deficit was reduced from 4.2 to 0.7 per cent of GDP between 1990 and 2000. This was accomplished largely by increasing the tax burden rather than by decreasing current expenditure relative to GDP, with adverse effects on the structure of industry and competitiveness.

The growth of the Italian economy averaged 1.6 per cent a year in the nineties, lower than the already modest rate recorded by the other European countries.

In the first half of the nineties the fall in domestic demand associated with the action to adjust the budget was offset by the robust growth in exports stimulated by the devaluation of the lira in 1992.

In the second half of the decade support from domestic demand was not lacking, but rigidities in the goods and factors markets obstructed the response of supply.

Reforms were launched to liberalize markets, reduce the direct role of the State in managing economic activity, reorganize the financial system and revise regional development policy. Despite the progress in making good the delays that had been accumulated over the preceding decades, the innovations introduced did not completely eliminate the structural impediments to the full exploitation of the economy's growth potential.

In the absence of a vigorous correction of the trend of public spending, the tax burden grew between the second half of the eighties and the second half of the nineties by more than six percentage points, from 36.9 to 43 per cent of GDP. The improvement in the efficiency of the public administration was not satisfactory.

The growth of productivity in industry was disappointing. Competitiveness was also eroded by the emergence of new competitors in the range of products in which Italy's export-oriented firms had specialized.

In the first half of the nineties the contribution of net exports to GDP growth was positive, averaging 1 percentage point a year; in the second half it was negative by an average of 0.4 percentage points a year.

Over the decade as a whole Italian exports' market share declined by around one fifth. Pricing strategies geared to rebuilding profit margins at the expense of volume growth initially contributed to the contraction. The results for Italian exports, even worse in the years following the Asian crisis, were attributable not only to the loss of price competitiveness but also to the product composition. Italian goods are prevalently medium tech and therefore exposed to the competition of the recently industrialized countries. Furthermore, demand for these products is growing much more slowly than that for high-tech goods.

In the second half of the decade the behaviour of Italian domestic demand was in line with that of the other euro-area countries and grew at an average annual rate of 2.4 per cent. Investment and the acceleration in household spending contributed. In recent years the easing of the fiscal constraint, the moderate revival of wage growth and the abatement of inflation fostered a gradual recovery in private sector disposable income.

After collapsing in 1993, investment recovered to record rapid growth, fueled by the upturn of the economy and the favourable financial conditions of firms. An important role was played by the temporary tax incentives of 1994 and 1995, the corporate income tax reform introduced in 1997 and 1998, and the reliefs of 1999 and 2000. In the second half of the decade investment other than construction expanded at an average annual rate of more than 6 per cent; in 2000 it amounted to 12 per cent of GDP, the highest figure among the main euro-area countries.

Around half of the investment growth between 1995 and 2000 came from the machinery and equipment component. Investment in intangible assets increased by nearly 10 per cent a year; although it rose, such investment's share of the total remained below 5 per cent.

The reduction in the budget deficit was accompanied by a decrease in public investment; between 1990 and 2000 this declined as a proportion of GDP by around 1 percentage point, to 2.4 per cent. The process of closing the large gap in infrastructure endowment between Italy and the rest of Europe came to a halt.

The fragmentation of Italian industry increased and the underground part of it expanded. Istat estimates that the ratio of the value added of underground activity to GDP rose by around 2 percentage points between 1992 and 1997. In the last few years economic policy action has aimed at bringing irregular activity into the open. Its share of total activity is estimated to have been 15 per cent in 1998.

The small size of firms adversely affects private-sector R&D spending. Between 1990 and 1999 such expenditure fell from 0.8 to 0.6 per cent of GDP, thereby widening the gap vis-à-vis the other European countries, where the average stands at 1.2 per cent.

The dualism of the economy has grown more pronounced owing to the relative scarcity of public capital and infrastructure and the difficult environment in the South.

With the employment crisis of the early nineties, income inequality among Italian households grew. The percentage of low-income households rose and the proportion of workers earning low pay increased.

The recovery of employment that began in 1995 primarily regarded the more flexible forms, in response to the reforms introduced in the labour market. Between 1989 and 1999 the share of fixed-term workers in total payroll employment increased from 6 to 10 per cent, that of part-time workers from 5 to 8 per cent. Over the same period the percentage of workers with low pay rose from 8 to 17 per cent.

From 2000 onwards the spread of fixed-term and part-time jobs slowed but the growth in full-time permanent employment picked up, thanks in part to the social contribution reliefs decided in October of that year and extended to 2003. Between July 1999 and July 2001 permanent jobs accounted for nearly two thirds of the total growth in payroll employment.

The transformation of the banking system since the mid-nineties has been far-reaching. For breadth and depth, the only historical parallel is the upheaval of the 1930s.

The process of concentration has produced Italian banks with the size to compete internationally and to assist Italian firms in expanding their business abroad.

Consolidation within the banking industry is proceeding with a major operation. The functional, organizational and operational problems within existing groups must be resolved rapidly. It is important to complete the restructuring of large banks. The process must now be extended fully to medium-sized banks and those belonging to certain categories.

The capital soundness and the efficiency of the banking system are essential in order to sustain a new phase of economic development.

Banking foundations have played a decisive role in creating the new configuration. It will be possible to specify their tasks better, within the framework of more pronounced geographical decentralization, by stressing their role in socially useful projects and circumscribing — in a strictly consistent fashion and in the most appropriate ways — their relations with the banking system.

Two months away from the changeover to the new currency, the preparatory work of the public administration, the banking system and the Bank of Italy has intensified. Our institution is committed to ensuring that the changeover takes place without any hitches and in complete security.

4. The outlook

The economic results for 2001 will be less favourable than was forecast at the beginning of September. In the United States private forecasting institutions now expect output to grow by only 1 per cent year on year, reflecting the weakness of consumer spending. In Japan deflation continues: the forecast is for a contraction of about 0.5 per cent year on year.

In Europe, growth will be less than 2 per cent.

In Italy, the Forecasting and Planning Report estimates GDP growth of 2 per cent in 2001. Given essentially constant raw material prices, the inflation rate should average 2.8 per cent for the year as a whole, in line with the forecasts of recent months.

The current phase of the cycle, both internationally and domestically, is marked by uncertainty.

The mood is not pessimistic; on the contrary, there is confidence in the prospects for economic growth in the medium term.

The fundamentals of the world's largest economy are such as to allow growth in the coming years at rates not far removed from those achieved in the second half of the nineties.

The budgetary package of $80 billion passed immediately after the attacks of 11 September comes on top of $110 billion of tax cuts for 2001-02 enacted last May.

These measures were possible thanks to the good state of the public finances. An additional $70 billion of economic measures is now before Congress. This expansionary action will begin to raise the growth rate as early as the first half of 2002.

The lowering of the Fed's reference rates by four percentage points since the beginning of the year, from 6.5 to 2.5 per cent, has created the conditions for supporting the incomes of heavily indebted households, preventing excessive declines in share prices and relaunching investment. Domestic and international confidence in the US economy has kept the dollar strong.

In Europe, the British economy shows signs of an upturn in the last part of the year. In the euro area, the economy is suffering from the effects of sluggish German growth. The French economy continues to grow slowly.

In Italy, the Bank of Italy's regular survey of investment plans in industry at the end of September found a continuing propensity to invest, at only slightly lower rates than in the last few years.

Polls taken after the terrorist attacks have found bewilderment, a wait-and-see attitude, not lack of confidence. The uncertainty of the moment has produced a pause in demand but does not alter the prospects for growth. The action needed to achieve a high rate of growth in 2002 must be taken.

It is necessary to bolster the expectations of a recovery in economic activity, which are also reflected in the financial markets.

Credit, at what are historically low interest rates, remains abundant. Lending continues to expand appreciably faster than economic activity.

New stimulus to domestic demand should stem from an increase of about one per cent of GDP in infrastructure investment. Central and local government cannot bear the entire burden of this increase.

The funds allocated for investment support in the Finance Bill must serve as a catalyst. The procedures for determining who is responsible for carrying out works must be defined.

Project planning and contracting procedures need to be improved, impediments and jurisdictional conflicts must be removed, and the correctness of operations and payments must continue to be guaranteed, together with protection of the environment.

Projects of high infrastructural value that can be quickly initiated, especially in the South, must be identified and the related procedures defined, *inter alia* on the basis of the public works legislation under discussion. The dispersion of funds among many small projects that has marked the last few years must be avoided. The projects where the suspension of funding and activity annuls the benefits on the supply side of the resources already committed must be completed.

The measures to encourage the repatriation of capital, to bring underground economic activity into the open, and to provide incentives for the reinvestment of profits will be more effective in a context of economic expansion. They will help to sustain and accelerate it.

As I had occasion to observe in testimony before Parliament, economic policy will be enhanced and rounded out if it is accompanied by a programme of reforms aimed at gradually bringing down the ratio of current public spending to GDP and laying the basis for a progressive, significant and lasting reduction in the tax burden.

The business community must respond by increasing its capacity for innovation and promptly seizing the new opportunities. Labour and saving are assets our society possesses. With consistent policies we must encourage their ever more productive use in harmony with the purposes of development.

Reducing the tax and social security burden and curbing expenditure create the conditions for raising the potential growth rate of the economy, for a lasting and stable expansion. In this way it will be possible to achieve a permanent reduction in the government deficit, which until now has been largely entrusted to temporary measures, and in the future to accomplish the definitive adjustment of the public finances.

The reforms must be introduced promptly, in the course of the next year.

They will immediately make a major contribution to boosting effective demand in the medium term.

The shortfall in public capital formation in the South, but also in the more highly developed areas of the Centre and especially the North, where the bottlenecks are most evident, offers hitherto unexploited scope for an expansion of economic activity.

An improvement in the functioning of the public administration and public services, along the lines set forth in the Government's programmes, can contribute greatly, in view of its macroeconomic importance and its interactions with other sectors, to the efficiency and competitiveness of the entire economy.

The possibility of faster growth, of pulling the economy out of its stall in the immediate future, is within the reach of the Government's economic policy.

Hesitation and the inevitable difficulties must be overcome.

A choral effort is required. It is necessary to deploy all the instruments at our disposal in a complex, but consistent, strategy designed to ensure the country's future, to consolidate the growth of employment, to foster young people's entry into the world of work.

To increase confidence, to eliminate pockets of poverty and shrink the area of underground and irregular activity, and to create conditions of civil and economic well-being for households in difficulty and for future generations.